McKinsey&Company

Is Ireland's population ready for retirement?

Finance Services October 2015

Nick Hoffman
Sorcha McKenna
Fabrice Morin

Contents

Executive summary

Ireland is at a crucial juncture with its pension system as options to strengthen it continue to be debated. While there are numerous possible approaches, the fact base on the situation has long been needed and is underdeveloped.

To assess the situation, McKinsey has created a database on personal finances and retirement readiness based on an extensive survey of more than 2,000 Irish households. This database not only provides a granular view on the financial situation of households, but also allows the assessment of real-world impact of many proposed changes to the pensions system.

Using this database we have assessed the current situation of the Irish pension system against three key measures (Exhibit 1):

1. Poverty in retirement – a household's ability to meet basic financial needs in retirement. Other countries can envy Ireland's position on this dimension. The poverty rate in retirement stands at 6.9 per cent, lower than in most large OECD countries. The poverty rate in retirement in Ireland is also lower than the average poverty rate across all age groups.

2. Standard of living adjustment – a household's ability to retire from employment without having to significantly reduce consumption. The fact that 29 per cent of households may be forced to materially reduce their consumption levels when they reach retirement is a cause for concern. Our database shows that lower-income households do relatively well on this measure as the current state pension replaces a large share of their pre-retirement spending. Households with average and above average incomes are much more likely to be exposed to a standard of living adjustment when they retire. These households require a high retirement income to maintain their relatively higher pre-retirement standards of living. While many of these households are members of private pension plans, most of those who are at risk among the group do not have access to a pension plan or do not contribute sufficiently to it.

3. System sustainability – the retirement system's ability to maintain current benefits levels in the future despite demographic or other pressures. This should be the greatest cause for concern. Current contribution levels to the Social Insurance Fund will be insufficient to continue to pay current levels of benefits in the future. In addition, annual expenditure on pay as you go public sector pension benefits will increase three-fold over the next four decades.

One approach to solve the sustainability challenge would be to increase contributions while maintaining State Pension benefits as they are. This would require additional contributions to the Social Insurance Fund of five per cent of salary from all workers.

At the opposite end of the spectrum, if contributions levels are not adjusted upwards, benefits will invariably have to be reduced. A reduction of 35 per cent in State Pension costs would be needed to address the sustainability issue if there is no increase at all to contributions levels. This would cause the number of people that face a significant negative adjustment to their standard of living when they retire to rise from 29 per cent to above 50 per cent. Poverty rates in retirement would also increase. Moreover, in almost all cases, individuals will need to shift how they think about the State Pension system – from

Exhibit 1

Summary assessment of Ireland's retirement system

Poverty in retirement

- Poverty rate in retirement stands at 6.9%, lower than most large OECD countries
- Poverty rate in retirement is lower than poverty rate of overall population (8.4% according to the OECD)

Standard of living adjustment

- While 71% of working households are on track to retire without significant adjustment, 29% are not
- Most of the households that are not on track are mid- to high-income and participate in a pension plan

System sustainability

- State pension is unsustainable; if nothing is done before 2035, benefits will need to be cut by 35%, affecting poverty and leading to 50% of households not being on track
- Similar sustainability challenge with public sector pensions

SOURCE: McKinsey

viewing it as a system that guarantees an adequate income in retirement to a system that provides a basic minimum level of retirement income that needs to be supplemented with private savings.

Any solution that aims to improve the overall pensions system without addressing sustainability issues will not stand the test of time. While a number of alternative approaches can be considered, all solutions will likely need to build on the elements of the system that are currently working well while encouraging Irish workers to put more aside. It will be important to act in the short- to medium-term, however, moving too quickly with a solution that is inappropriate could be even more damaging.

Introduction

Developed economies around the world are struggling to find sustainable pension frameworks to address structural pressures exerted by their ageing populations. Life expectancy in developed economies continues to rise with individuals aged over 65 forming an increasing proportion of the overall population.

There are significant concerns related to retirement in Ireland today. Pension coverage is low. The population is ageing. Many suffered losses in income and wealth during the financial crisis and are still paying back debts contracted when asset values were very high. Yet, Irish households own in aggregate more than EUR 1 trillion in net assets, of which only a fraction is in the pension system (see Box 1). In this context, there is a real need and appetite for more specific and granular data on the preparedness of Irish households today.

In this context, McKinsey has embarked on a comprehensive study of retirement readiness in Ireland based on an extensive survey of more than 2,000 households. This analysis leverages the methodology and frameworks that we have used and tested to analyse retirement systems in other countries.

Box 1:
Overview of the Irish pension system

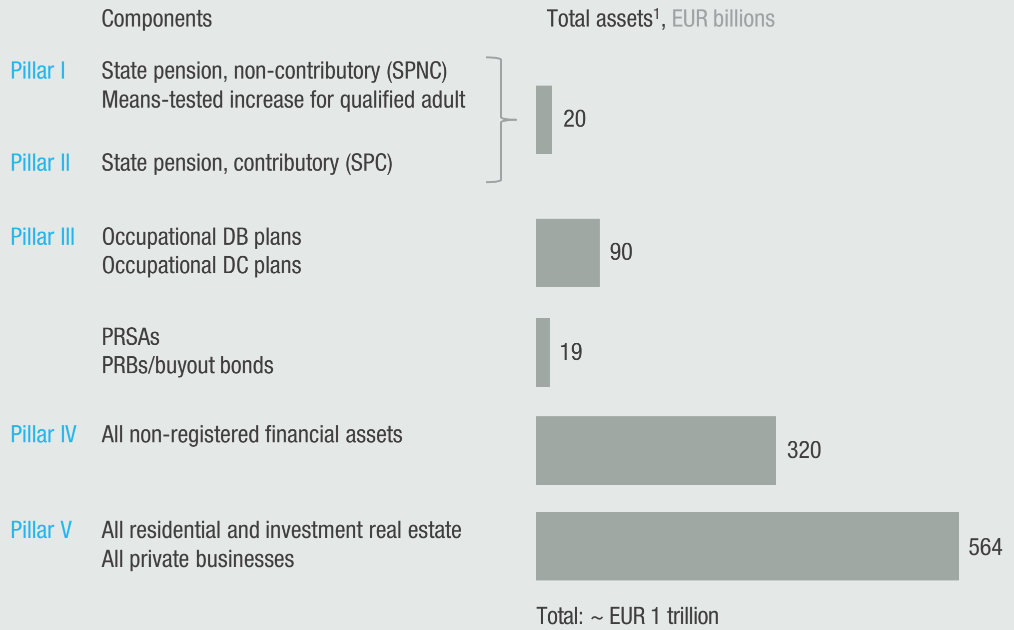
There are five pillars in the Irish pension system that play a role in securing the retirement readiness of Irish households:

- Pillar I – Universal means-tested public pension (State Non-Contributory Pension)
- Pillar II – Basic public pension for all eligible workers (State Contributory Pension)
- Pillar III – Voluntary workplace plans, both group (defined-benefit and defined-contribution schemes) and individual (e.g., personal retirement savings accounts and retirement annuity contracts)
- Pillar IV – All non-registered financial assets (e.g., stocks, bonds, mutual funds and life insurance)
- Pillar V – Net value of individual real estate and business equity

In Ireland, assets are heavily skewed towards Pillars IV and V with total asset values of approximately EUR 320 billion and EUR 564 billion respectively. This compares to significantly smaller asset values of approximately EUR 126 billion in Pillar III assets and approximately EUR 20 billion in Pillar I and II assets.

Exhibit A

The pillars of the Irish retirement system



1 Estimates based on most recent data available

SOURCE: OECD review of the Irish Pension System, 2014; National Pensions Reserve Fund Commission Annual Report and Financial Statements; IAPF; Eurostat; Central Statistics Office; The Pensions Authority; Department of the Environment

Real estate equity from the primary residence and non-financial assets is not included in our assessment of retirement readiness as most households do not plan to liquidate their primary residence or private businesses in retirement. However, secondary real estate, such as investment properties, is included as these assets are more often used to fund expenditure in retirement.

Assessing the retirement situation in Ireland

Assessing the outcomes offered by a retirement system is complex and requires an analysis of three important dimensions: poverty in retirement, standard of living adjustment in retirement and system sustainability. While on the poverty front the situation of Irish retirees is no worse than Irish workers and comparable to the position of other countries, our analysis shows that close to one-third of households will face material standard of living adjustments and that system sustainability is a cause of concern. In this context, while multiple paths could be considered to improve the system, the solution will invariably require the generation of more savings over the coming years.

Poverty in retirement

This first measure looks at the portion of the population that will not have a minimum absolute amount to live in retirement.

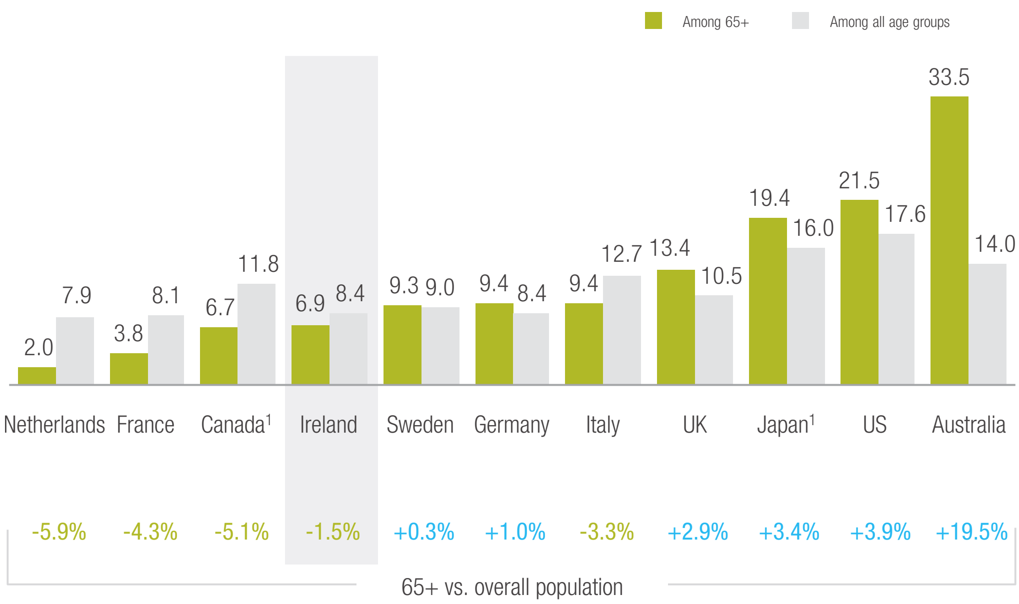
Analysis indicates that income poverty does not discriminate by age with poverty levels among working households equivalent to poverty levels among retired households. The overall average poverty rate across the entire population ranges between approximately 8[1] and 15[2] per cent, depending upon the estimates used, while poverty levels in retirement are at approximately 7 to 9 per cent (see Exhibit 2).

Poverty levels in Ireland are no greater in retirement than in pre-retirement. Thus the search for solutions to poverty requires a holistic view, as opposed to one that targets retirees. This report therefore does not include an analysis of the absolute minimum level of income retirees should or could achieve.

Exhibit 2

Poverty rates across select OECD countries

Percentage of individuals with equivalent incomes less than 50% of national median, 2012



1 Data for 2011 or latest available

SOURCE: OECD 2011/12, most recent data available at time of publication

Standard of living adjustment

This second measure looks at a household's ability to move from working life to retired life without a significant standard of living adjustment (i.e., its ability to maintain consumption levels). We find that more than two-thirds of the nation's households are on track to retire without a significant standard of living adjustment. The result may be reassuring to some but still stands below other countries such as Canada where we performed a similar analysis and found that 83 per cent of the population is on track.

McKinsey assessed the situation in Ireland based on an extensive survey of the financial situation of Irish households. We applied the Retirement Readiness Index (RRI) measure to each individual household, a process that we have used in other countries in the past. The RRI is a measure of a household's ability to maintain the standard of living experienced during working life into retirement (see Box 2 for more details).

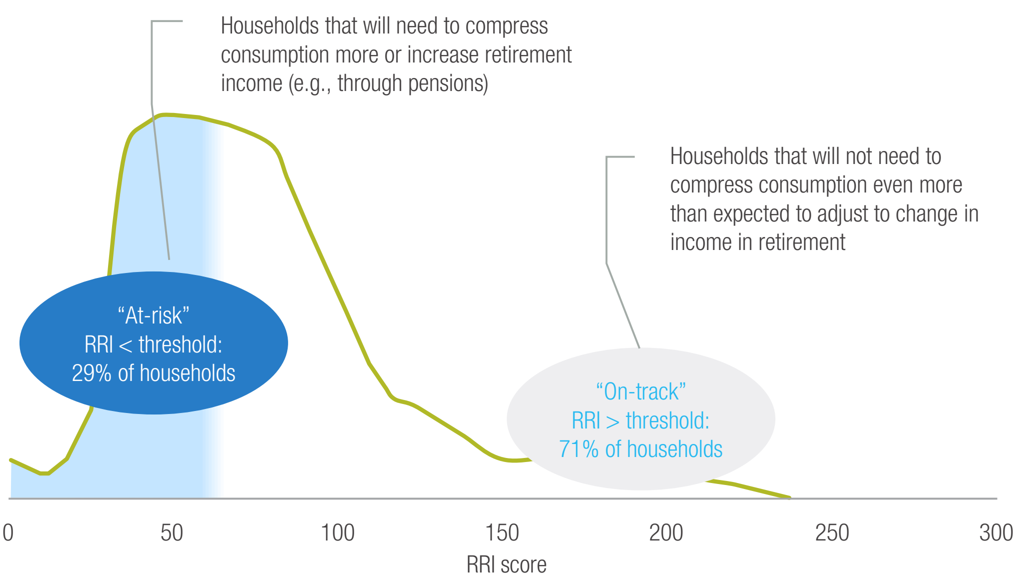
Based on our analysis, many working age Irish households are on track to maintain their standard of living in retirement. However, the dispersion in RRI scores is wide and while more than two-thirds of the nation's households are on track, nearly one-third of households are below the minimum RRI threshold (see Exhibit 3). This means that their post-retirement income will not allow them to maintain their pre-retirement standard of living into retirement.

The conclusion that nearly one-third of Irish households are not prepared for retirement is robust and holds under a number of different scenarios for core assumptions. For instance, the percentage of households on track varies by 1 per cent or less on a wide range of alternative assumptions regarding life expectancy, return on assets and annuity rates.

Exhibit 3

Irish Retirement Readiness Index – 2015

Percentage of Irish households; RRI value



Note: There is little regional variation of the percentage above threshold across provinces (Connaught-Ulster – 69%, Leinster – 74%, Dublin – 73%, Munster – 70%); ~ 3% of households have an RRI greater than 300 and are not shown; min. threshold of 75 for Q1 and 65 for Q2 - Q5

SOURCE: Retirement Readiness Index Model 2015

Box 2:
Retirement Readiness Index (RRI)

McKinsey's Retirement Readiness Index (RRI) is a measure of a household's retirement preparedness, defined as the standard of living a household will be able to afford in retirement relative to its peak working life standard of living. In Ireland, the RRI takes into account all five pillars of retirement, including all financial assets held by households and part of home equity and other non-financial assets (the RRI base scenario, however, excludes primary residence equity as well as business equity as these assets are often not liquidated in retirement).

An RRI of 100 means that a household is on track to maintain the same level of consumption in retirement that it had before retirement. This level is defined by the annual real amount a household has available for consumption after taxes and fixed charges, assuming no inheritance beyond home equity and non-financial assets. A household with an RRI above 100 could increase its consumption in retirement or maintain it and leave an inheritance. A household with an RRI below 100 would be forced to reduce its consumption in retirement or delay retirement.

Based on research and analysis, those below the RRI threshold of 75 for the first-income quintile and of 65 for all other income groups have been defined as not being on track for an adequate retirement income. These consumptions levels were triangulated through OECD research on consumption compression, analysis of consumption compression in retirement based on data from the Central Bank of Ireland and the Vincentian Partnership for Social Justice, assessment of survey results and comparison with the RRI analysis done by McKinsey in Canada.

Survey methodology

The analysis underlying this report is based on a survey conducted by Behaviours & Attitudes between February and April 2015. Out of a total survey of 2,275 households of all age groups, a sample of 1,662 working-age households (i.e., between the ages of 25 and 65) was retained for the analysis. Responses were weighted by age, region, household composition and social class to generate a representative view of the Irish population.

To project the working-age households' paths to retirement, the survey gathered detailed information on the households' assets, debt and savings habits.

Retirement Readiness Index methodology

The RRI measures the ratio between the projected amount available for consumption in retirement and the consumption level pre-retirement. Disposable income in retirement is obtained by projecting the current assets and future savings of each household, assuming a long-term compounded real return on assets of 2.25 per cent per year. Overall RRI and percentage of on track households are not sensitive to adjusting most assumptions.

Assets at retirement are then converted into annual income through retirement based on a real rate of return of 1.5 per cent. Annuities insure each household against longevity risk. These annuities could be acquired over multiple years to manage market timing risk. Income from SPC, SNPC and DB plans (if applicable) is added to the annuity coming from accumulated savings. Income taxes are applied using the current tax rates. Projections take into account the tax treatment of deferred tax and post-tax savings. The analysis assumes that the current tax rates and public pension benefits remain unchanged.

With these robust results showing a gap in the retirement readiness of the Irish population, it becomes very important to understand how the profile of households that are not on track differs from that of households that are on track. An initial important observation relates to differences among demographic groups, especially in terms of income level (see Exhibit 4). Our analysis shows that the most exposed segments are the medium-to-high income groups, especially those without a pension plan or with low contribution rates into their pensions.

Lower-income households are on track to maintain their standard of living in greater proportion, mainly because the State Pension replaces a large share of their pre-retirement spending. These households are likely to have had low levels of discretionary spend both in pre-retirement and retirement. There does not seem to be an imbalance between standard of living in working life and standard of living in retirement for this group. A very small proportion of lower-income households are in a situation where they should save more during working life to have more to spend in retirement.

Households in the mid- to high-income quintiles are more likely to be exposed to a standard of living adjustment in retirement. The reason for this is that these households require a higher retirement income to replace their relatively higher pre-retirement consumption. They cannot rely solely on the State Pension and they need a private pension or other forms of retirement savings to afford retirement.

Adding to the pressure, mid- to high-income groups are more likely to hold mortgage debt and to carry it into retirement. For instance, 20 per cent of the highest-income households between the ages of 35 and 65 carry a mortgage with a term that will extend into retirement, compared to less

Exhibit 4

Percentage of households on track for retirement by income quintile and age group

Income quintile[1]	Age group 25 - 34	35 - 44	45 - 54	55 - 64	Avg. income
Q1 *(lowest)*	94	96	93	99	EUR 13K
Q2	68	81	74	78	EUR 23K
Q3	56	60	65	54	EUR 35K
Q4	55	65	58	51	EUR 54K
Q5 *(highest)*	65	73	71	62	EUR 101K
Share of non-retired working-age households	24	37	19	19	

1 Household income cut-offs: Q1 < EUR 19K, Q2 < EUR 30K, Q3 < EUR 43K, Q4 < EUR 65K, Q5 > EUR 65K

SOURCE: Retirement Readiness Index Model 2015

than 10 per cent for lower-income groups. These projected mortgage payments in retirement reduce the financial resources available for other needs and add to the financial pressures of these households.

Finally, higher-income households (quintiles 4 and 5) have the highest level of pension plan coverage (Exhibit 5). The majority of households with a pension plan have a higher median RRI and are, therefore, better prepared for retirement (see Exhibit 6). The retirement readiness gaps in the high-income segment are driven by the households that do not have access to a pension plan and those households that have access but do not contribute sufficiently.

Only approximately 45 per cent of Irish private sector workers are covered by a voluntary occupational pension plan[4]. This number is similar to OECD estimates of coverage rates in other countries where pension coverage at work is voluntary[5].

System sustainability

The State Pension system is under increasing pressure with rising deficits. This projected rise in deficits from an estimated EUR 2 billion in 2015 to an estimated EUR 5.6 billion per annum by 2030 and EUR 11.6 billion per annum by 2040 is due to a number of economic factors including an increase in the older population[6] (see Exhibit 7). While this situation is not unique to Ireland, and other OECD countries are facing similar pressures, the magnitude of deficits means measures to address them need to be considered.

This situation is further compounded by a high level of reliance on the state system for retirement income by Irish

Exhibit 5

Pension coverage by age and income quintile

Percent

x Percentage covered by a plan[1]   x Percentage covered by a defined contribution plan

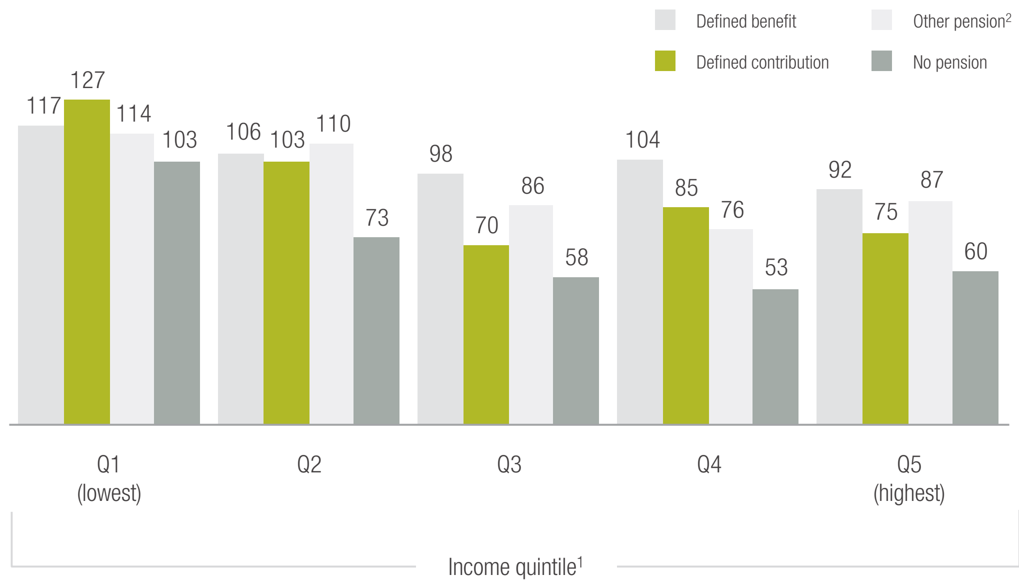
Income quintile[2]		Age group 25 - 34	35 - 44	45 - 54	55 - 64
Q1 *(lowest)*	Percentage covered by a plan	12	25	25	17
	Percentage covered by a defined contribution plan	6	7	10	7
Q2	Percentage covered by a plan	25	38	35	17
	Percentage covered by a defined contribution plan	15	10	9	2
Q3	Percentage covered by a plan	41	65	51	56
	Percentage covered by a defined contribution plan	26	19	9	8
Q4	Percentage covered by a plan	54	52	71	77
	Percentage covered by a defined contribution plan	22	27	25	12
Q5 *(highest)*	Percentage covered by a plan	89	76	92	88
	Percentage covered by a defined contribution plan	22	44	32	20

1 Defined benefits (DB) plan, defined contributions (DC) plan, occupational pension, personal retirement savings account (PRSA) or other personal pension plans
2 Household income cut-offs: Q1 < EUR 19K, Q2 < EUR 30K, Q3 < EUR 43K, Q4 < EUR 65K, Q5 > EUR 65K
Note: Calculations based on primary income earner only; percentage covered by defined contribution is out of all primary income earners and not those covered by a plan only; average contribution rate is only for those primary income earners with a defined contribution plan who had a contribution > 0%

SOURCE: Retirement Readiness Index Model 2015

Exhibit 6

Median RRI score by quintile and pension plan type

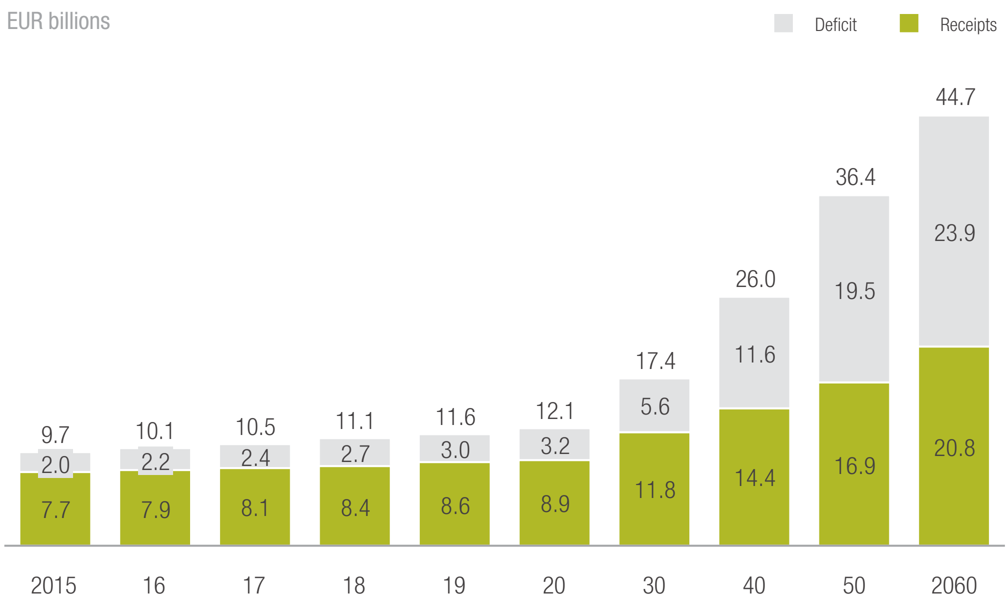


1 Household income cut-offs: Q1 < EUR 19K, Q2 < EUR 30K, Q3 < EUR 43K, Q4 < EUR 65K, Q5 > EUR 65K. Sample size of 1,651. Q1: 127, Q2: 204, Q3: 323, Q4: 326, Q5: 316. 320 respondents received government transfers; 35 had invalid responses
2 PRSAs or other private pension plans

SOURCE: Retirement Readiness Model 2015

Exhibit 7

Projected Social Insurance Fund receipts and deficits (2012 estimates)



SOURCE: Actuarial review of the Irish pension system households with approximately 80 per cent[7] of retirees receiving some form of government payment.

The Social Insurance Fund (SIF) provides social welfare payments and State Contributory Pension for all workers (Pillar II)[8] with pensions constituting the largest proportion of its expenditure (approximately 65 per cent in 2013)[9].

The SIF is currently facing rising deficits as it is funded on a pay-as-you-go basis by contributions from employers and employees, with the state obliged to cover the gap between the contributions and expenditure. The cumulative deficit is estimated to rise to approximately EUR 133 billion by 2040.

While concerted efforts have been made to reduce the SIF deficit (such as amendments to the State Non-Contributory Pensions in 2012[10]), structural systematic reforms are required to effectively curb it.

In addition to the SIF, pay-as-you-go public sector defined benefit funds also pose a sustainability challenge[11].

Local authority pensions are funded by the Local Government Fund and the balance of pay-as-you-go pensions are funded directly by the Exchequer.

Analysis conducted by the Comptroller and Auditor General in 2010 found accrued liability with respect to public service pensions to be approximately EUR 116 billion; similar to at the end of 2009 (present value of future liabilities payable over approximately 60 to 70 years). Updated estimates in 2012[12] found that this accrued liability had decreased by 16 per cent to approximately EUR 98 billion largely due to public service pay and pension cuts that were introduced in 2009.

In 2009, a government audit indicated the annual deficit was projected to rise from approximately EUR 1.5 billion in 2018 to EUR 7.3 billion per annum by 2058. This constitutes a cumulative deficit of EUR 157 billion by 2058, over double the value of the 2011 IMF bailout of Ireland[13].

Implications of our findings

McKinsey's analysis of retirement readiness in Ireland cautions that challenges faced by the pension system are multi-faceted. The issue of retirement readiness is currently a significant cause for concern. However, sustainability of the broader system is likely the greatest challenge and therefore needs to be tackled first.

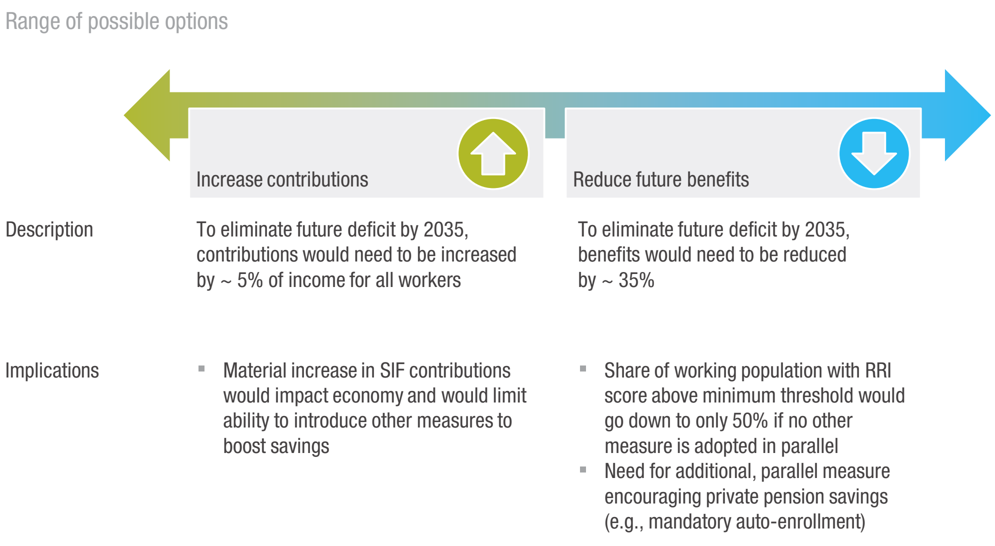
If left unaddressed, the system sustainability issue will force a significant decline in the ability to maintain standard of living in retirement and may result in higher poverty rates in retirement. Solving this problem will inevitably require contribution increases and/or benefit reductions (Exhibit 8). If benefits are reduced, additional savings will be needed to compensate. Moreover, individuals will need to shift how they think about the State Pension system – from viewing it as a system that sufficiently provides adequate income in retirement to a system that provides a basic minimum level of retirement income that needs to be supplemented with private savings.

While a number of alternative approaches can be considered to address the situation, a few general principles will likely be common to all solutions

- It would appear logical to define the solution to the system sustainability challenges first as it will inevitably have an impact on the needs for pension coverage and for additional personal savings.
- In all cases, savings should be encouraged as Irish workers will need to put more aside in the future.
- Changes to the system should aim to preserve the elements that are currently working well – amongst others a State Pension system that provides universal

Exhibit 8

Options to address the projected Social Insurance Fund deficits



SOURCE: McKinsey

coverage to many individuals and a private pension system that allow many households to save sufficiently for retirement.

Basing changes on a thorough analysis of the problem and phasing their implementation would limit potential negative impacts on the economy; acting too quickly may do more harm than good.

Other countries have adopted reforms with solutions designed to meet the specific needs and challenges they face. In Ireland's situation, solutions need to be tailored to principally address forced standard of living adjustments and sustainability issues.

Conclusion

The challenge for the Irish government, retirement providers, employers and individuals is to arrive at a solution that enhances the retirement prospects of those currently at risk, while strengthening the sustainability of the pension system.

The first step in tackling this challenge is to ensure a shared and granular understanding of the issues before embarking on solutions. The analysis of the issues needs to examine poverty in retirement, the ability to maintain standard of living and system sustainability. These three dimensions are important as there are inherent trade-offs between alleviating poverty concerns in retirement, ensuring most individuals maintain their standard of living in retirement and strengthening the retirement system's sustainability.

Current discussions on retirement in Ireland tend to be focused on one or another of the aspects of the system and are not framed around the central questions that need to be answered first. We believe that these fundamental questions include:

1. How can Irish households be incentivised to increase their overall savings for retirement?

2. How can the State Pension system's rising deficits be balanced while maintaining appropriate levels of pension payments to those most in need so that retirees do not descend into poverty, and so that saving to maintain standard of living in retirement does not become an impossible challenge for households?

3. How can incentives to increase overall savings be supplemented with targeted solutions to achieve better retirement readiness across Irish households and, especially, the segments we have found most at risk?

Focusing on these fundamental questions and on measures of success for a set of solutions will be an important step. We hope that our fact base on the retirement system in Ireland will help further inform the debate and lead to appropriate solutions.

Nick Hoffman
Sorcha McKenna
Fabrice Morin

The authors would like to acknowledge the contributions of colleagues Daniel Corcoran, Rico Garcia Ondarza and Ruchi Sharma to this report.

Footnotes

[1] This estimate is based on OECD Social Indicators, which use a threshold of income less than 50 per cent of median income to define poverty.

[2] This is estimate is from the EU Survey on Income and Living Conditions – Ireland (2013), which uses a threshold of income less than 60 per cent of median income to define poverty.

[3] Our research together with our analysis of the survey results suggested that the minimum RRI threshold for households in the lowest-income quintile is 75 and for other quintiles it is 65.

[4] The result of triangulation of data from The Irish Longitudinal study on Ageing (TILDA), Central Statistics Office, Pensions Authority and survey results.

[5] For instance, from 2009 to 10, in the United Kingdom the coverage rate was 43.3 per cent.

[6] These figures are outcomes of analysis based on the 2012 Actuarial Review of the Social Insurance Fund.

[7] TILDA Report on Supplementary Pensions and Incomes of Retirees (2012).

[8] OECD Review of the Irish Pension System, 2014, page 30.

[9] OECD Review of the Irish Pension System, 2014, page 30.

[10] Department of Social Protection statistics show that expenditure on state non-contributory pension has reduced from approximately EUR 1 billion in 2009 to approximately EUR 960 million in 2013.

[11] Public sector pensions are largely pay as you go. The only exception is certain commercial state companies that have their own pension plans.

[12] Updated actuarial review conducted by the Department of Public Expenditure and Reform.

[13] These figures are outcomes of our analysis based on the report prepared by the 2009 Comptroller and Auditor General

Financial Services Practice
October 2015

Design contact: Visual Media Europe
www.mckinsey.com